***United States Court of Appeals***

***for the Second Circuit***


# APPELLANT'S REPLY BRIEF

# 75-7106

## United States Court of Appeals

FOR THE SECOND CIRCUIT

MACAULEY WHITING,

*Plaintiff-Appellant,*

—against—

THE DOW CHEMICAL COMPANY,

*Defendant-Appellee.*

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

# REPLY BRIEF FOR PLAINTIFF-APPELLANT


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### Preliminary Statement

Plaintiff-appellant Macauley Whiting submits this reply brief in response to the brief of defendant-appellee The Dow Chemical Company ("Dow" or the "Company").

### Argument

In this case, an independent woman who thinks for herself and manages her own affairs, sold a company's securities which had come to her from her family and which had, for all practical purposes, been in her family since her

grandfather had founded the company. Neither directly nor indirectly did her husband give her any of the securities. Since 1957, she has regularly sold securities in this company in order to diversify her investments. The company now seeks to attribute the most recent of these transactions to her husband, who is a director, in order to establish liability under section 16(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78p(b) [Main Brief of plaintiff-appellee ("Main Br."), pp. 5-6]. If Mrs. Whiting's transactions are not attributed to her husband, neither the overall goal of section 16(b) nor its simplistic application to transactions clearly within its coverage would be impaired.

As stated in the Main Brief [pp. 2, 8] and conceded by Dow [Brief of defendant-appellee ("Dow Br."), p. 2], this appeal presents a question of law. For the purposes of section 16(b), can ownership of a spouse's securities be attributed to an insider if he did not control either the securities or the transactions at issue? The court below specifically found:

> "[T]here is no evidence that he [Mr. Whiting] controls her [Mrs. Whiting's] decisions concerning even the general aspects of her management of her estate." [A 149].*

In addition, Mrs. Whiting's long-standing ownership of Dow stock has never relieved Mr. Whiting of any expenses he would normally incur because, as the court below also found:

> " . . . Mr. Whiting does contribute virtually his entire salary to defray the family expenses which are met primarily by Mrs. Whiting." [A 149].

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* "A" refers to the Joint Appendix.

As shown at length in the Main Brief [pp. 10-20], no case has ever attributed to an insider the transactions of another, whether spouse, unrelated person, partnership, or corporation, without a finding of control by the insider. Dow does not dispute this fact. Instead, Dow contends that the decision below was correct on either of two grounds: as a matter of law, Mr. Whiting is liable because he derived "pecuniary benefits" from his spouse's ownership of Dow stock even though he had no control (the alternative three forms of this argument are discussed in Point I, *infra*); or, as a matter of fact, the findings of fact were erroneous because Mr. Whiting exercised a "controlling influence" over his spouse's securities transactions, including her transactions in Dow stock (this argument is considered in Point II, *infra*).

## POINT I

**Because Mr. Whiting Did Not Control His Spouse's Securities Transactions, These Transactions Cannot Be Attributed to Him.**

When it enacted section 16(b), Congress did not intend the provision to have a flexible, far-ranging interpretation; and the Supreme Court has strictly construed the statute in cases whose facts make them dispositive here. *Reliance Elec. Co.* v. *Emerson Elec. Co.*, 404 U.S. 418 (1972); *Blau* v. *Lehman*, 368 U.S. 403 (1962).

In *Blau* v. *Lehman, supra,* the Court rejected an argument that section 16(b) should be extended to transactions by persons other than officers, directors and 10% shareholders, stating that liability under the statute was not to be determined "by adding to the 'prophylactic' effect Con-

gress itself clearly prescribed in § 16(b)." [368 U.S. at 414].* In *Reliance Elec. Co.* v. *Emerson Elec. Co., supra,* the Supreme Court rejected the argument that two separate transactions, intentionally designed to avoid liability under section 16(b), could be treated as one transaction within the meaning of the statute. Disregarding this, Dow argues that two individuals who made separate transactions should be treated as one individual in order to impose liability under the statute.

In support of this position, Dow first argues that, "read literally," the language of section 16(b) imposes liability upon an insider for "any" profit realized by him on "any" short-swing transactions in the stock of his company, regardless of who actually executes the transactions [Dow Br., Point I A, p. 22]. Under Dow's test, if an insider's neighbor and close friend used the proceeds from short-swing transactions in securities of the insider's corporation to build a swimming pool which the insider's family used freely, section 16(b) would require the insider to repay the neighbor's profit on the transactions. Or, if that same neighbor bequeathed to the insider the proceeds from short-swing transactions in the stock of the insider's company, the insider must disgorge those "profits realized by him."

To make this construction of the statute less awkward than it is, Dow limits the term "profits realized by [the

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* In the *Blau* case, *supra,* the Court of Appeals had held the individual defendant liable for that part of the partnership's profit that was his by law. Other cases have rightly held that renunciation of the profit or rescission of the offending transactions does not negate the application of the statute. *See, e.g., Volk* v. *Zlotoff,* 285 F. Supp. 650 (S.D.N.Y. 1968). Here, Mr. Whiting had no right to rescind the sales by Mrs. Whiting nor any renounceable right to her profits.

insider]" to those transactions in which the insider received "benefits substantially equivalent to ownership" [Dow Br., pp. 24-25]. Of course, neither the test nor the limitation are found in the "plain language" of section 16(b) or in its legislative history. No court has ever construed the phrase "profits realized" in this manner, and no one has ever suggested that "benefits substantially equivalent to ownership" can be extracted from the plain language of section 16(b). As the legislative history makes clear [Main Br., pp. 8-9], Congress was aware of the problems posed by members of an insider's family and could have extended the arbitrary provisions of section 16(b) to transactions by persons other than the insider. Instead, Congress determined to reach those potential abuses through the control provisions in section 20 of the 1934 Act, 15 U.S.C. § 78t, or the general antifraud provisions of section 10b of the Act, 15 U.S.C. § 78j(b). The language of the statute is, indeed, plain; but it refers only to a "director or officer," not to a spouse or any other person or "benefits substantially equivalent to ownership."

Next, Dow asserts that if the application of the statute to both Mr. and Mrs. Whiting is unclear, the "possibility of abuse" test may be used to resolve this ambiguity in coverage. Because the relationship between Mr. and Mrs. Whiting presented a "possibility of abuse," any transactions in securities from which Mr. Whiting derived "benefits substantially equivalent to ownership" must be attributed to him [Dow Br., Point I B, pp. 29-32].

Of course, Dow cites no authority for the application of the "possibility of abuse" test to a case involving the attribution of another person's securities transactions; and some cases have reached the contrary result. In *Mould-*

*ings, Inc.* v. *Potter,* 465 F.2d 1101 (5th Cir. 1972), *cert. denied,* 410 U.S. 929 (1973), the Court of Appeals expressly rejected an argument that the trial court should have applied the "possibility of abuse" test to evaluate transactions made by the insider's designees. Instead, the Court of Appeals held that the lower court had correctly applied the control test, saying:

> "Potter urges that the district court erred in not applying the 'possibility of abuse' test to the transaction in question so as to take the matter out of § 16(b). Our conclusion is that this test is inapplicable on the facts of this case. The transaction in question was no more than a mere sale and purchase. It fits precisely into the design of § 16(b). That design was to take any possible profit away from insiders fitting within the scope of § 16(b). Potter was such an insider." [465 F.2d at 1104].

In *Gold* v. *Sloan,* 486 F.2d 340 (4th Cir. 1973), *rehearing en banc denied,* 491 F.2d 729, *cert. denied,* 419 U.S. 873 (1974), the Court of Appeals for the Fourth Circuit expressly limited the "possibility of abuse" test even more, saying:

> "No difficulty has been experienced in applying the statute and what has been described as its 'crude rule of thumb' to the 'traditional cash-for-stock transactions that result in a purchase and sale or a sale and purchase within the six-month, statutory period * * *.' The right of recovery in such a situation is plain. *The real problem for the courts in construing the statute, however, has arisen in connection with the 'unorthodox' transaction, one in which the statutory concept of 'purchase' and 'sale' is blurred and where its identification within such concept is 'borderline.'*
>
> • • •

> ". . . The 'possibility of abuse' test applies only to one transaction, the exchange of stock pursuant to a merger." [486 F.2d at 343, 349, footnotes omitted and emphasis supplied].

In keeping with the Supreme Court's injunction that the words of the statute are to be "read literally," the courts have used the "possibility of abuse" test only to construe specific words that are ambiguous, not to conduct a factual inquiry into a relationship between the insider and another. It has never been used to extend the coverage of the statute in order to make two persons, who execute separate transactions, into one person within the coverage of the statute. But even if this radically different and complex use of the test is adopted, Mr. Whiting satisfied it when the District Court found:

> ". . . Mr. Whiting does not communicate with his wife concerning the affairs of the company. . . . She does not, as a matter of practice, discuss individual transactions with her husband, and there is no evidence that he controls her decisions concerning even the general aspects of the management of her estate." [A 149].

Last, Dow argues that the District Court properly created a rebuttable presumption that an insider "realizes" profits from short-swing transactions in the spouse's securities if he derives from them "benefits substantially equivalent to ownership" [Dow Br., Point I C, pp. 36-37]. As the Main Brief shows, the courts, the Securities and Exchange Commission, and the commentators have all rejected the notion that any such presumption has been added to the arbitrary and mechanistic provisions of section 16(b) [Main Br., pp. 23-28]. Dow asserts that the District Court "nowhere approved a presumption of beneficial ownership." Instead,

Dow contends that an insider is presumed to realize profits if he "derives benefits substantially equivalent to ownership" from the spouse's securities transactions [Dow Br., pp. 37-38]. This is a distinction without a difference. In effect, the court below created a *per se* rule for families although treating it as if it were a rebuttable presumption. However this presumption is characterized, if the findings in this case do not preclude attribution, no happily married couple living together could ever escape liability.

The District Court's presumption rests on the language used by the Securities and Exchange Commission to create a rebuttable presumption of beneficial ownership under the reporting provisions of section 16(a); but the Commission has expressly disclaimed any intention to create a presumption that an insider has "beneficial ownership," *i.e.*, "derives benefits substantially equivalent to ownership," of the spouse's securities under section 16(b) [Main Br., pp. 24-25.] Even if such a presumption did exist under section 16(b), Mr. Whiting rebutted that presumption when he proved that he did not control Mrs. Whiting or her securities.

In sum, the plain meaning of the statute excludes the application of section 16(b) to both Mr. and Mrs. Whiting. The statutory requisite of control must be proven in order to treat them as if they were one person. At best, the "possibility of abuse" test applies only to ambiguous *words* in the statute, not to questions involving the overall scope of the statute and certainly not to questions involving the attribution of one person's transactions to another. The concept of "benefits substantially equivalent to ownership" does not appear in the language of the statute; has not been used in attribution cases under section 16(b); and

on the findings of fact by the trial court, could not be a proper basis for decision here because Mr. Whiting had no control over the disposition of the securities, their voting, or any of the other ordinary aspects of ownership. At most, his style of life was improved because his wife owned them.

## POINT II

### The Trial Court Correctly Found That Mr. Whiting Did Not Control His Spouse's Securities Transactions.

For actions tried without a jury, Rule 52(a) of the Federal Rules of Civil Procedure provides the following standard for appellate review:

> "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

Under the "clearly erroneous" test, the party seeking to overturn the trial court's findings of fact must establish that the trial court could not have found as it did, not merely that the trial court could have found otherwise. *Blau* v. *Lehman, supra,* at 408-09; *Simon* v. *New Haven Board & Carton Co.,* CCH Fed. Sec. L. Rep. ¶ 95,015, at 97,551 (2d Cir. 1975); *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1280-81 (2d Cir. 1973); *Wolf* v. *Frank,* 477 F.2d 467, 473 (5th Cir.), *cert. denied,* 414 U.S. 975, *rehearing denied,* 414 U.S. 1104 (1973); in *Wolf* v. *Frank, supra,* a recent securities litigation, the Fifth Circuit said:

> "The defendants' briefs and arguments are predicated upon facts and inferences and conclusions that the trial court neither found nor was compelled to find. In the welter of charges and counter charges the ensu-

ing obfuscation can be visioned away by the application of a relatively few simple legal propositions, the most elementary principle being that appellate courts are governed by the 'clearly erroneous' test of Rule 52(a) of the Federal Rules of Civil Procedure when they review District Court fact findings. In applying this test, we have said:

> 'The question is not simply whether the reviewing court would have found otherwise but whether the trial court could permissibly find as it did. The reviewing court should upset a finding only when it "is convinced on the whole record that the finding does not reflect the truth and right of the case." Wright, Federal Courts § 96, at 432.'

[Citation omitted]. Defendants' brief oftentimes totally fails to evidence an awareness, much less an understanding, of this controlling principle of appellate jurisprudence." [477 F.2d at 473].

In the case at hand, the District Court heard the testimony of Mr. and Mrs. Whiting and viewed their demeanor on the stand for almost a week [A 2]. In its opinion, the District Court flatly found that Mr. Whiting did not control even the most general aspects of the management of Mrs. Whiting's estate, let alone her specific transactions in Dow stock. According to Dow, this Court may, nevertheless, find that Mr. Whiting exercised a "controlling influence" over Mrs. Whiting's securities transactions [Dow Br., p. 43]. This contention must be rejected for two reasons: first, the "controlling influence" test proposed by Dow is found nowhere in the statutory language of the 1934 Act, but rather in the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 *et seq.;* and second, the contention is merely an effort to overturn the District Court's findings of

fact, which are supported by the undisputed facts in the record.

As authority for its novel application of "controlling influence" to section 16(b), Dow relies solely on decisions construing the Public Utility Holding Company Act of 1935 [Dow Br., pp. 25-26, n.12]. Sections 2(a)(7) and (8) of that Act contain an express "controlling influence" test as part of its definitions of "holding company" and "subsidiary corporation." 15 U.S.C. §§ 79b(a)(7) and (8). In an early decision under the Public Utility Holding Company Act, the Securities and Exchange Commission found a significant difference between "controlling influence" and "control." *H.M. Byllesby & Co.*, 6 S.E.C. 639 (1940). In that decision the Commission stated:

> "[I]t seems clear that Congress meant by the term 'controlling influence' something less in the form of influence over the management or policies of a company, than 'control' of a company." [*Id.* at 651].

The courts, too, have recognized that Congress intentionally differentiated "controlling influence" and "control." *North American Co.* v. *SEC*, 327 U.S. 686, 693 and n.5 (1946); *Koppers United Co.* v. *SEC*, 138 F.2d 577, 581 (D.C. Cir. 1943); *American Gas & Elec. Co.* v. *SEC*, 134 F.2d 633, 641 (D.C. Cir.), *cert. denied*, 319 U.S. 763 (1943); *Public Serv. Corp.* v. *SEC*, 129 F.2d 899, 902-03 (3d Cir.), *cert. denied*, 317 U.S. 691 (1942); *Pacific Gas & Elec. Co.* v. *SEC*, 127 F.2d 378, 381-82 (9th Cir. 1942), *aff'd on rehearing en banc*, 139 F.2d 298 (1944); *Detroit Edison Co.* v. *SEC*, 119 F.2d 730, 738-39 (6th Cir.), *cert. denied*, 314 U.S. 618 (1941). Congress' failure to include "controlling influence" in the 1934 Act proves its satisfaction with the present "control" provision of that statute. Of course, Dow cites no authority

for applying a "controlling influence" test to any provision of the 1934 Act, let alone the objective provisions of section 16(b).

At best Dow's use of "controlling influence" is an attempt to overturn the trial court's findings of fact without shouldering the awesome burden of the "clearly erroneous" test, but the "facts" upon which Dow relies to establish a "controlling influence" are flatly contradicted by the findings below. Dow has consistently attempted to prove that Mr. Whiting directed Mrs. Whiting's investment program, but the District Court found:

> "Upon occasion Mrs. Whiting consults her husband concerning the desirability of certain investments *in areas of his expertise,* and although she does not invariably follow his advice she appears to have considerable respect for his opinion." [A 150, emphasis supplied].

As of December 31, 1973, Mrs. Whiting owned tax shelters, certificates of deposit, commercial paper, common stocks, and bonds, totalling more than 100 different securities [Plaintiff's Trial Exhibit 5]. Of these holdings and all others purchased and sold by her since the beginning of her diversification effort in 1957, a period of sixteen years, defendant showed that Mr. and Mrs. Whiting had discussed the purchase of only eight securities: two bank stocks; two oil drilling funds; one municipal bond for construction of a stadium, because he wanted better seats for the Detroit Lions football games; and three common stocks [Trial Transcript, pp. 200-08, 209-11, 330-38, 475-79, 522-26].

As further evidence of Mr. Whiting's "controlling influence," Dow asserts that the decision to increase Mrs. Whiting's annual sales of Dow stock from five percent of her

holdings to ten percent was made jointly by Mr. and Mrs. Whiting at a meeting with their accountants [Dow Br., p. 44]. Mr. Whiting testified:

> "Q. My question is, was there an increase during that 18-month period up through the end of '73 in the divestment so that in excess of 2 percent was being sold in 1973? A. Yes. There was no change, as I understood it, in the long-range program, but because of special considerations in 1973 *Mrs. Whiting decided to double and redouble the amount.*" [A 42-43, emphasis supplied].

Mrs. Whiting also testified that she made this decision:

> "Q. You stated at the suggestion of Mr. Kessler at Goldstein, Golub in approximately April, 1973, the decision (494) was reached to increase the disposition program to approximately 5 percent, is that correct? A. I made that decision, yes.
>
> * * * * *
>
> "(495) * * * Q. Do you recall traveling to New York for a meeting (496) at Goldstein, Golub sometime between May 18, 1973 and October 29, 1973? A. No, but I think the decision was made somewhere between those two dates.
>
> Q. To go from five to ten percent? A. Yes.
>
> Q. You think that was done by telephone? A. I believe so." [A 61].

Contrary to Dow's assertion, Mrs. Whiting's decision to increase her disposition program from five percent to ten percent was not made in a joint meeting with Mr. Whiting and the accountants but in a telephone conversation in which Mr. Whiting did not participate [Trial Transcript, pp. 328, 445-46, 456-60]. The District Court believed this testimony, finding:

> " . . . *his wife* had increased the pace of her disposition of Dow stock toward the latter part of 1973." [A 157-58, emphasis supplied].

Mr. Whiting supposedly admitted his "controlling influence" over his wife's transactions because he failed to disclaim beneficial ownership of his spouse's securities in the Form 4s he filed with the Securities and Exchange Commission [Dow Br., pp. 18, 47]. Mr. Whiting relied on the following advice of Dow's general counsel in a memorandum to directors and officers:

> "Some directors or officers may disclaim beneficial ownership by their wives, but I think there is considerable doubt as to whether they could safely rely on such a disclaimer to avoid the invocation of the Section 16(b) penalties." [A 76].

Thus, Mr. Whiting's "admission" was nothing more than a layman's reliance on legal advice given him by the Company. In that same memorandum, the general counsel also advised Mr. Whiting that the exercise of his option was not a purchase within the meaning of section 16(b):

> "There is, however, one exemption from the foregoing rules which will be of interest to you and that has to do with shares acquired pursuant . . . to The Dow Chemical Company's option plans. The exemption provides that the acquisition of shares pursuant to option plans which meet certain requirements (which the Dow plans do meet) is exempt from Section 16(b). This means that in the exercise of any options held by you, you need not be concerned about the fact that you may have sold other Dow shares during the preceding six months or do sell Dow shares during the succeeding six months."

Dow suggests that the general counsel later corrected this erroneous advice to Mr. Whiting [Dow Br., p. 18, n. 7], but the District Court's findings on this point are clear:

> "It appears that he exercised his option at the time he did under the erroneous impression that this was not a 'purchase' for purposes of liability under § 16(b)." [A 158].

Dow makes a number of outrageous charges about Mrs. Whiting's loan to her husband for the financing of the option exercise. For example, it was not a loan; it was, in reality, a gift [Dow Br., p. 8, n.2]. After hearing the testimony of Mr. and Mrs. Whiting, however, the court below found: Mr. Whiting had commenced negotiations with a bank for a loan to exercise the option; the Whitings' accountants recommended instead that the exercise be financed by a loan from Mrs. Whiting; the Whitings initially rejected this suggestion; but they ultimately consented to a loan at an annual rate of 7% payable over an indefinite period of time [A 158]. They did this solely to retain the tax benefits which were insistently pressed upon them by their accountants [A 44-45, 118; Trial Transcript, pp. 285, 355-59; Deposition of Stuart Kessler, pp. 156-58]. In its findings, the District Court did not even hint that the transaction was anything other than a loan.

In addition, Dow says that the promissory note evidencing the loan from Mrs. Whiting to her husband was "purposely backdated," implying some deceitful purpose on their part [Dow Br., p. 7]. Nothing in the record suggests such a motive on Mr. Whiting's part. He executed the note exactly as it was prepared for him by his accountants, including the date of December 27, 1973 on which the loan had actually been made [A 46, 122; Trial Transcript, pp.

357-59, 501]. Furthermore, Mr. Whiting made no attempt to conceal the fact that the note was executed later than that date. On February 25, 1974, before this lawsuit began, Mr. Whiting, through his attorneys, notified special counsel for Dow by letter that the note evidencing the loan from Mrs. Whiting had not yet been executed but was then in preparation [Plaintiff's Trial Exhibit 16].

Dow also argues that Mr. Whiting had no capacity to repay the loan [Dow Br., pp. 43-44]; but he could have repaid it by selling some of the 21,420 shares he received when he exercised the option, which is the way almost all optionees pay for their option stock. The exercise price was $24.3125 per share. At the time Mrs. Whiting made the loan and her husband exercised the option, the price per share had risen to $58.25, more than twice the exercise price. During the first five months of 1975, Dow stock reached a high of $92.50, almost four times the exercise price. Mr. Whiting could then have sold 5,630 shares, repaid the entire loan from his wife, and still had 15,790 shares with a market value of $1,460,575. Obviously, the capacity to repay Mrs. Whiting's loan was never in question.

In sum, Dow has taken the phrase "controlling influence" from the Public Utility Holding Company Act, in which the phrase appears, and engrafted it on the 1934 Act in spite of the fact that the 1934 Act clearly uses only "control," a different concept. In the alternative, Dow asks this Court to review the District Court's findings of fact and, in effect, determine them to be "clearly erroneous"; but the findings by the trial court were more than justified by the record: Mr. Whiting exercised no control over any of his wife's securities holdings or transactions, let alone her Dow stock.

## CONCLUSION

The District Court should have applied the test of control to determine whether or not Mrs. Whiting's transactions could be attributed to her husband. Dow has cited no persuasive authority for the application of any different test. For these reasons, the judgment of the District Court should be reversed with a direction to enter judgment for plaintiff-appellant Macauley Whiting on the findings of fact made by the court below.

Respectfully submitted,

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